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INDEX OF CASES.

IN THE

Supreme Court of the United States.

No. , October Term, 1948.

MATHER & CO.,

Petitioner,

v.

COMMISSIONER OF INTERNAL REVENUE,

Respondent.

PETITION FOR WRIT OF CERTIORARI.

To the Honorable, the Justices of the Supreme Court of the United States:

The Petition of Mather & Co., a corporation organized under the laws of the Commonwealth of Pennsylvania, respectfully represents:

This is a petition for a writ of certiorari to the United States Court of Appeals for the Third Circuit to review judgment affirming a decision of The Tax Court of the United States.

SUMMARY STATEMENT OF THE MATTER INVOLVED.

This is a case involving the proper interpretation of certain involved provisions of the Revenue Act of 1926, as amended, and like provisions of the Internal Revenue Code, which seem never to have been passed upon by this Court. Income and Excess Profits Taxes in excess of $163,000 are involved (R. 27a).

As originally enacted (Appendix 27), Section 203 (b) (4) of the Revenue Act of 1926 provided that no gain or loss should be recognized where property is transferred to a corporation by one or more persons solely in exchange for stock and securities in such corporation, and further

provided that in the case of an exchange by two or more persons, the amount of the stock and securities received by each must be "substantially in proportion to his interest in the property prior to the exchange."

In *U. S. v. Hendler,* 303 U. S. 564, this Court passed upon a similar provision of the Revenue Act of 1928 and held that a transfer was not made "solely in exchange for stock or securities", but that "other property or money" was also received where the transferee corporation assumed a liability of the transferor. Following that decision and because of it, Section 203 (b) (4), among others, was amended retroactively by the Revenue Act of 1939 (Appendix 27) so as to provide:

> "Where the transferee assumes a liability of a transferor, or where the property of a transferor is transferred subject to a liability, then for the purpose only of determining whether the amount of stock or securities received by each of the transferors is in the proportion required by this paragraph, the amount of such liability (if under section 213 of the Revenue Act of 1939 it is not considered as 'other property or money') shall be considered as stock or securities received by such transferor."*

It is the proper interpretation of the above as applied to the facts of this case which will decide the issues. How to determine whether the stock or securities are "substantially in proportion" is a problem upon which the Courts of Appeal have divided and the Commissioner has vacillated. In addition, the amendment quoted above has added to the confusion and it is no easy matter to tell what it means. This Court has never passed upon its meaning. Upon its true construction will depend the outcome of this case. The courts below have in the present case, in the judgment of the petitioner, so construed the amendment as to ignore completely the parenthetical clause of

* This is now a part of Section 112 (b) (5) of the Code.

the amendment and thus in effect hold the amount of liability assumed shall *always* be treated as stock or securities received by the transferor although the amendment says that is true only "if under Section 213 of the Revenue Act of 1939 it is not considered as 'other property or money'." That is the legal problem involved. It is a pure question of law.

STATEMENT OF BASIS UPON WHICH IT IS CONTENDED THE COURT HAS JURISDICTION.

The statute under which jurisdiction is invoked is Section 1254 (1) of the Act of June 25, 1948 c. 646. (28 U. S. C. A. § 1254).

The date of the judgment of the Court of Appeals for the Third Circuit sought to be reviewed is January 3, 1949.

The case involves the question of recognition of gain or loss, under Section 203 (b) (4) of the Revenue Act of 1926, as amended, upon the transfer of property to a corporation by two or more persons solely in exchange for stock in such corporation. The Tax Court ruled that the transfer came within the provisions of said section, that no gain or loss was recognized by the transfer, and that the cost basis of the property to the corporation was the basis of the transferor. The Circuit Court affirmed the decision of The Tax Court.

QUESTIONS PRESENTED.

In 1926 four partners transferred all of the assets of the partnership and certain additional real estate to a corporation (formed for the purpose) in exchange for the preferred and common stock of the corporation—the corporation also assuming the liabilities of the partnership. The questions involve the proper method of arriving at the cost basis of the real estate to the corporation:

1. What is meant by the words "substantially in proportion to his interest in the property prior to the ex-

change"? Do they require a comparison between the proportionate interest of each transferor in the property transferred and his proportionate interest in the stock exchanged therefor—the so-called "control" test as held by the court below; or do they require a comparison between the value of the property transferred by each and the value of the shares of stock received by each transferor—the so-called "relative value" test as held by the First and Fourth Circuits?

2. Should the amount of the liabilities assumed by the corporation be considered as "stock or securities" in determining whether the amount of stock and securities received by each of the partners was "substantially in proportion to his interest in the property prior to the exchange" as required by the Revenue Act of 1926 as amended?

REASONS RELIED ON FOR ALLOWANCE OF WRIT.

1. There is a conflict of Circuits upon one of the most important legal questions involved. The question is whether what has become known as the "relative value" test or the so-called "control" test should be used in determining whether the stock and securities received by a transferor are "substantially in proportion to his interest in the property prior to the exchange." In the "relative value" test a comparison is made between the value of the interest of each transferor in the property before the exchange and the value of the shares of stock of each after the exchange. This view has been sustained by the Fourth Circuit, *United Carbon Co. v. Commissioner,* 90 F. 2nd 43 (1937) and by the First Circuit, *Bodell v. Commissioner,* 154 F. 2nd 407 (1946), upon the general ground that the section is primarily concerned with gain or loss to the transferors. (See Brief, *infra,* page 15.) On the contrary the court below in the case at bar adopted the "control" test which compares the proportionate interest of each transferor in the total assets before the exchange and his

proportionate share in the total issue of stock after the exchange. (See opinion of court below, Record 29.) Thus it is First and Fourth Circuits against the Third Circuit.

2. There is another important question of law involving the proper construction of provisions of the Revenue Act of 1926 as amended and the Code which has not been, but should be, settled by this Court. As previously pointed out, following the decision of this Court in *U. S. v. Hendler*, 303 U. S. 564, Section 203 (b) (4) of the Revenue Act of 1926 was amended retroactively by the Revenue Act of 1939 so as under certain circumstances to require that liabilities assumed by the transferor shall be considered as stock or securities received by the transferee. To say the least, the amendment is none too clearly worded (Appendix 27). It is now a part of Section 112 (b) (5) of the Internal Revenue Code, the portion of the Code dealing generally with "Recognition of Gain or Loss." Few provisions of the Code are more important to taxpayers. This Court alone can authoritatively clarify the meaning of the amendment.

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Attorneys for Petitioner.

BRIEF IN SUPPORT OF PETITION FOR WRIT OF CERTIORARI.

OPINIONS OF THE COURT BELOW.

The opinion of The Tax Court is reported in 7 T. C. 1440. It appears in the Record at page 17a.

The opinion of the Court of Appeals for the Third Circuit is reported in 171 F. 2nd 864. It appears in the Record at page 29.

JURISDICTION.

The opinion of the Court of Appeals was filed January 3, 1949. The statute under which jurisdiction is invoked is Section 1254 (1) of the Act of June 25, 1948; 62 Stat. ; Title 28, U. S. C., Section 1254 (1).

CONCISE STATEMENT OF THE CASE.

This proceeding arose because of the disallowance by the respondent of deductions from income of $270,000 and $82,500 in 1942 and 1943, respectively, claimed by the petitioner as ordinary losses on the sales of real estate in those years. These disallowances resulted in deficiencies in income and excess profits taxes for those years in the total sum of $262,107.36 (R. 17a).

On October 8, 1945, the petitioner petitioned The Tax Court of the United States to redetermine the deficiencies (R. 1a). The case was heard, and on December 31, 1946, The Tax Court promulgated its decision (R. 17a), holding that the real estate was acquired by the petitioner in a nontaxable exchange, and, therefore, that the basis for determining the amounts of the petitioner's losses on the real estate which it sold in 1942 and 1943 was the same as it would have been in the hands of the transferor, instead of the cost to petitioner in 1926, when it acquired the real estate. On February 13, 1947 The Tax Court entered its

decision redetermining the deficiency in the total sum of \$163,766.57 (R. 27a). On May 12, 1947 the petitioner filed its petition for review by the Circuit Court of Appeals for the Third Circuit. On January 3, 1949 the Court of Appeals entered judgment affirming the decision of The Tax Court (R. 40a).

The petitioner is a corporation organized under the laws of Pennsylvania, and commenced business on January 1, 1927. It was organized for, and has been continuously engaged in the business of insurance agents, brokers, and adjusters (R. 3a). Prior to incorporation, the business was conducted as a partnership with four partners whose interests in the assets and earnings of the partnership were (R. 4a):

Charles E. Mather	35 percent
Victor C. Mather	25 percent
Gilbert Mather	20 percent
Josephine C. Mather	20 percent

On October 29, 1926 the partners entered into a written agreement to incorporate the business and formed petitioner with an authorized capital stock of \$510,000 consisting of 5,000 shares of 6% cumulative preferred stock of a par value of \$100 per share, and 1,000 shares of common stock with a par value of \$10 per share, and an agreed value at the time of transfer of \$50 per share (R. 5a). Only the common stock had voting rights (R. 18a). All the assets and good will of the partnership, except the assets and good will of the New York office, were transferred to the petitioner. The value of the good will of the partnership was found by The Tax Court to be \$40,000 (R. 19a). The tangibles of the partnership transferred consisted of real estate valued at \$150,000 and furniture valued at \$35,000, or a total of \$185,000. Intangible assets transferred, including cash and accounts receivable, totaled \$1,299,978.78 (R. 18a). Accounts payable of the partnership, amounting

also to $1,299,978.78, were assumed by the petitioner (R. 18a).

In exchange for this property the partners received preferred and common stock of the petitioner as follows (R. 19a):

	Preferred	Common
Charles E. Mather	648	250
Victor C. Mather	462	250
Gilbert Mather	370	250
Josephine C. Mather	370	50
	1850	800

The common stock was issued in consideration of the purchase of the good will of the partnership (R. 19a). The remaining 200 shares of authorized common stock were unissued (R. 19a). The Tax Court found that the value of the common stock was $50 per share and the preferred stock $100 per share (R. 19a).

In addition, Charles E. Mather subscribed for the remaining 3,150 shares of preferred stock. These shares were issued to him in exchange for his promissory note of $50,000 and the conveyance to the petitioner of premises 1325-27 Arch Street and of premises 2039 Chestnut Street. All transfers were made late in December 1926, effective as of January 1, 1927 (R. 19a). As of December 31, 1926, premises 1325-27 Arch Street had a fair market value of $350,000, of which $290,000 was the value of the land and $60,000 the value of the buildings. The premises were encumbered by a mortgage of $150,000 (R. 20a). As of December 31, 1926, premises 2039 Chestnut Street had a fair market value of $115,000 of which $85,000 was the value of the land and $30,000 the value of the building. The premises were encumbered by a mortgage of $50,000 (R. 20a). Both properties were conv[illegible]d to the corporation under and subject to the mortgages (R. 20a).

Accordingly the partners received 1,850 shares of preferred stock valued at $185,000 for the transfer to the petitioner of the tangible assets of the partnership, also valued at $185,000, and 800 shares of the common stock valued at $40,000 in exchange for the good will of the partnership, also valued at $40,000. In addition, Charles E. Mather received 2,650 shares of preferred stock valued at $265,000 for his total equity of $265,000 in premises 1325-27 Arch Street and premises 2039 Chestnut Street, and 500 preferred shares ($50,000) in exchange for his note of $50,000 —a total of 3,150 shares (R. 19a). Summarizing all of the above the partners transferred assets valued as follows, taking the good will at $40,000 (R. 19a):

Charles E. Mather		
Arch St. and Chestnut St. properties	$265,000	
35% partnership tangibles of $185,000	64,750	
Promissory note	50,000	
35% good will at $40,000	14,000	$393,750
Victor C. Mather		
25% partnership tangibles	$ 46,250	
25% good will	10,000	$ 56,250
Gilbert Mather		
20% partnership tangibles	$ 37,000	
20% good will	8,000	$ 45,000
Josephine C. Mather		
20% partnership tangibles	$ 37,000	
20% good will	8,000	$ 45,000
		$540,000

The partners received preferred and common stock valued respectively at $100 and $50 per share, as follows (R. 19a):

	Preferred		Common		Total
	No.	Value	No.	Value	Value
Charles E. Mather	3798	$379,800	250	$12,500	$392,300
Victor C. Mather	462	46,200	250	12,500	58,700
Gilbert Mather	370	37,000	250	12,500	49,500
Josephine C. Mather	370	37,000	50	2,500	39,500
	5000	$500,000	800	$40,000	$540,000

The gain or loss occasioned to each partner by the transfer was as follows:

	Value Transferred	Value Received	Gain	Loss	Diff. in %
Charles E. Mather	$393,750	$392,300		1,450	— 0.3
Victor C. Mather	56,250	58,700	2,450		+ 4.4
Gilbert Mather	45,000	49,500	4,500		+10.0
Josephine C. Mather	45,000	39,500		5,500	—12.2

In his individual income tax return for 1926, Charles E. Mather treated the transaction as a taxable transfer and reported a gain of $99,300 upon the transfer to the petitioner of premises 1325-27 Arch Street, and a gain of $25,400 upon the transfer to the petitioner of premises 2039 Chestnut Street—a total income tax liability of $15,587.50 on the total gain of $124,700. Neither Charles E. Mather nor any of the other partners reported gain or loss on the exchange of the partnership assets for the stock of the corporation (R. 20a).

On December 31, 1942 petitioner sold premises 1325-27 Arch Street for the sum of $20,000. Since the entire value of the buildings had been written off by depreciation claimed and allowed until 1934 and the demolition of the buildings in 1934, the petitioner incurred a loss of $270,000 ($290,000 the 1926 value of land—$20,000), plus $1,025 expenses or a total loss of $271,025. This is the loss claimed for the year 1942 which was disallowed by the Commissioner and accounts for all of the disputed deficiency in 1942 (R. 21a).

On December 30, 1943 petitioner sold premises 2039 Chestnut Street for the sum of $2,500. Since the entire value of the buildings had been written off by depreciation claimed and allowed until 1936 and the demolition of the buildings in 1936, the petitioner incurred a loss of $82,500 ($85,000 the 1926 value of land—$2,500), plus $128.50 expenses, or a total loss of $82,628.50. This is the loss claimed for the year 1943 which was disallowed by the Commissioner and accounts for the entire deficiency in 1943 (R. 22a).

The basis of petitioner's transferor for the properties in question, as found by The Tax Court, is as follows (R. 22a):

	Land	Buildings
1325 Arch Street	$75,250	$6,468
1327 Arch Street	59,579.67	6,468
2039 Chestnut Street	15,000	5,000

SPECIFICATION OF ERRORS.

1. The Court below erred in applying the so-called "control" test in determining whether the partner transferors had each received stock and securities "substantially in proportion to his interest in the property prior to the exchange."

2. The court below erred in its construction of Section 203 (b) (4) of the Revenue Act of 1926 as amended by the Revenue Act of 1939 (Appendix 27) to the effect that liabilities assumed by the transferee corporation must be considered as stock or securities received by the transferors for the purpose of determining whether the amount of stock or securities received by each transferor was in the required proportion.

3. The Court below erred in so construing Section 203 (b) (4) of the Revenue Act of 1926 as amended by the Revenue Act of 1939 (Appendix 27) as to ignore the qualification contained in the parenthetical clause of the amendment with respect to liabilities assumed.

4. The Court below erred in so construing Section 204 (a) (8) of the Revenue Act of 1926 as not to permit the transferor's basis to be increased "in the amount of gain . . . recognized to the transferor . . . under the law applicable to the year [1926] in which the transfer was made."

SUMMARY OF ARGUMENT.

I. In order to determine whether stock and securities received by each transferor was substantially in proportion to his interest prior to the exchange, the Court below went wrong in adopting a test which compares the percentage of each transferor in the total assets before and the total stock after the exchange—the so-called "control" test. All other Circuits which passed on the question have adopted the "relative value" test which compares the value of the interest of each transferor in the property before the exchange and the value of the shares of stock received by each after the exchange. The difference is illustrated by the tables below at pages 15 and 16. The first table illustrates the "relative value" test. It emphasizes the gain or loss to each transferor as the statute requires. The second table illustrates the "control" test. It ignores gain or loss, and emphasizes the percentage of each transferor in the total assets before and the total stock after the exchange. A comparison of the opinion below with excerpts from the opinions in a Fourth Circuit case at page 17 and a First Circuit case at page 18 not only points up the conflict but also supplies the best argument in support of the "relative value" test.

II. The Court below has erroneously construed a statute which admittedly was passed for the purpose of altering the rule of *U. S. v. Hendler*, 303 U. S. 564. That case had held that under the facts there involved, "liabilities assumed" were "other property or money" and hence the transfers were not made "solely in exchange for stock or securities" and gain was realized. Report No.

855 of the House (76th Congress), T. D. 4939, and Section 29.112 (k) Regulations 111, all support the petitioner's contention that the amendment was passed for the purpose of preventing a transaction which was otherwise tax-free from becoming taxable merely because liabilities had been assumed. But in the face of the admitted purpose of the Amendment as recognized by this Court, the Report of the House, the Commissioner's own Rulings and Regulations, the Court below held that a transaction otherwise taxable became tax-free because liabilities had been assumed—a purpose which Congress never had in mind. To reach that result, the Court had to ignore a very important clause in the amendment.

ARGUMENT.

I.

The "Relative Value" Test Followed by Other Circuits, and Not the "Control" Test as Adopted by the Court Below, Should Be Used in Determining Whether the Stock and Securities Received by Each Transferor Was Substantially in Proportion to His Interest in the Property Prior to the Exchange.

Section 203 (b) (4) of the Revenue Act of 1926 (44 Stat. 12; 26 U. S. Code Ann. "Internal Revenue Act 1924 to date" p. 149); *as originally enacted* provided as follows:

> (4) No gain or loss shall be recognized if property is transferred to a corporation by one or more persons solely in exchange for stock or securities in such corporation, and immediately after the exchange such person or persons are in control of the corporation; but in the case of an exchange by two or more persons this paragraph shall apply only if the amount of the stock and securities received by each is substantially in proportion to his interest in the property prior to the exchange.[1]

Four partners transferred property to a corporation and received in exchange preferred and common stock of the corporation. Immediately after the exchange the same persons were in control of the corporation. The result of the transfer showing the gain or loss occasioned to each partner by the transfer may be summarized as follows:

	Value Transferred	Value Received	Gain	Loss	Diff. in %
Charles E. Mather	$393,750	$392,300		$1,450	— 0.3
Victor C. Mather	56,250	58,700	$2,450		+ 4.4
Gilbert Mather	45,000	49,500	4,500		+ 10.0
Josephine C. Mather	45,000	39,500		5,500	— 12.2
	$540,000	$540,000			

1. This is now the first sentence of Section 112 (b) (5) of the Code.

It is, of course, of no general importance whether this petitioner wins or loses this case. But it is of the greatest importance to all taxpayers that this Court resolve the conflict among the Circuits upon the question whether upon such figures the transferors realize gain or loss or whether they do not.

The First and Fourth Circuits have held that gain or loss is realized upon such facts as are contained in the table. Gilbert Mather has gained 10% and Josephine C. Mather has lost 12.2%. This is a spread of 22.2%. The Courts which apply the "relative value" test say that in the face of such a spread it cannot be said that the amount of stock received by each transferor was substantially in proportion to his interest in the property prior to the exchange.

The Court below, in using the same figures, rejects the last column which shows the percentage gain or loss each transferor has sustained (Opinion, R. 33); and adopts a computation which "requires that the proportionate interest transferred by each be compared with the proportionate interest each received." Thus the Court below finds:

	Value of Property Transferred	Percent of Total	Value of Stock Received	Percent of Total	Variation
Charles Mather	$393,750	72.92	$392,300	72.65	— .27%
Victor C. Mather	56,250	10.42	58,700	10.87	+ .45%
Gilbert Mather	45,000	8.33	49,500	9.17	+ .84%
Josephine C. Mather	45,000	8.33	39,500	7.31	—1.02%
	$540,000	100.00	$540,000	100.00	

Because the "variation" is small, the Court held the stock received was substantially in proportion (Opinion, R. 33 and R. 35).

The "relative value" test places the emphasis on whether the *individuals* suffer gain or loss for that is what the section deals with. This construction emphasizes that the "stock and securities received by *each* is substantially in proportion to *his* interest in the property prior to the exchange." (Emphasis supplied.) On the other hand the "control" test compares the percentage of each partner in the total assets before and the total stock after the exchange, regardless of whether the transferors actually suffered a gain or loss.

So far as authority is concerned there is a clear conflict between *United Carbon Co. v. Commissioner,* 90 F. 2nd 43 (C. C. A. 4th, 1937) and *Bodell v. Commissioner,* 154 F. 2nd 407 (C. C. A. 1st, 1946) and the Court below. The Court below observed "Each approach can cite respectable authority in its favor" (Opinion, R. 33) and then adopts the control test as being "in conformance with that indicated in *Hartford Empire Co. v. Commissioner,* 137 F. 2nd, 540, 542 (C. A. 2, 1943) . . . and *Budd International Corp. v. Commissioner,* 143 F. 2nd 784, 791 (C. A. 3, 1944)." We think neither of those cases support the control test for in both of them, the result would be the same no matter which test is used and the problem is nowhere discussed in the opinions. But if the Court below is right, it merely underscores the conflict of Circuits.

This conflict can best be appreciated by comparing the "three cogent factors" upon which the Court below said "Our conclusion is based" (Opinion, R. 33-35) with the following excerpts from the *United Carbon* and *Bodell* cases.

In *United Carbon Co. v. Commissioner,* 90 F. 2nd 43 (C. C. A. 4th, 1937) the reasoning in support of the relative value test is thus stated (pp. 46-47):

> "It is manifest from a practical viewpoint that when an owner of property transfers it to a corporation in exchange for stock and thereafter his interest in the corporation is of a *value* substantially equivalent to the *value* of the property transferred, he has

realized no gain or loss; and hence Congress declared that in computing his income for purposes of taxation, no gain or loss from such a transaction should be recognized. But, on the other hand, if the asset possessed by the transferor after the exchange differs substantially in *value* from that which he previously possessed, a real change in his condition, for better or worse, has taken place; hence Congress provided that in such a case the exception to the general rule should not apply and the gain or loss involved in the exchange should be recognized. *The emphasis upon the individual transferor is noted in the provision that the paragraph shall apply only if the condition of substantial equivalency is met in the case of each transferor, so that no matter how many persons are involved, unless the transfer by each complies with the condition, none is privileged to avail* himself of the exception. * * *

"If, in accordance with this view, the tables above set out are examined, it will be seen that in a number of instances *there was a substantial difference* between the *value* of the asset possessed by the transferor before the exchange and the *value* of the stock received by him therein. Thus it appears that . . . the Humphreys Carbon Company [realized] *a gain of 12.17 per cent* . . . and the Central Carbon Company *a gain of 11 per cent* . . . and on the other hand that the Standard Carbon Company suffered *a loss of 9.10 per cent* . . . *It cannot be said of any of these exchanges that the condition of the transferor was substantially the same after as before the exchange, and hence it appears that the condition of the statute was not met.*" (Emphasis supplied.)

In *Bodell v. Commissioner*, 154 F. 2nd 407 (C. C. A. 1st, 1946) the Court reasoned as follows (pp. 411-413):

"We must now consider whether the words 'substantially in proportion' of Section 112 (b) (5) are to

be viewed in the light of the 'relative value' test or in the light of comparative control. An analysis of the cases shows that the Circuit Courts of Appeals have accepted either expressly or implicitly the 'relative value' test which was set forth in the *United Carbon* case. *Budd International Corporation v. Commissioner,* 143 Fed. (2d) 784 (C. C. A. 3d, 1943); *Commissioner v. Lincoln-Boyle Ice Co.,* 93 Fed. (2d) 26 (C. C. A. 7th, 1937); *Blair v. Commissioner,* 91 Fed. (2d) 992 (C. C. A. 2d, 1937); *Snead v. Jackson Securities & Investment Company,* 77 Fed. (2d) 19 (C. C. A. 5th, 1935) cert. den. 296 U. S. 599. We have been unable to discover any decision in appellate courts supporting the 'control' test. On the authority of the cases cited above and on sound reasoning, we believe that the 'relative value' test is the test called for by the statute." (Page 411)

"*The question in the latter part of the Section* [112 (b) (5)] *is not whether each of the several transferors suffers a substantial loss or gain in value over the value of the assets he transferred but whether the gain or loss suffered by each was substantially proportionate to the gain or loss suffered by every other transferor.*" (Page 412)

"Having decided that the proper test for determining substantial proportion is the relative value test and having determined that the correct application of that test results in the spread of 11.04% between Group 1, the group which suffered the least by virtue of the exchange, and Group 6, the group which suffered the most, we must now decide whether the ultimate finding of fact by the Tax Court that a substantial disproportion existed between these two groups, was warranted. We feel that it was. *A spread of over 11% is indeed substantial.* A simple illustration bears this out. If A and B, each owning $100,000 worth of property,

transfer this property to a corporation in exchange for stock and A receives stock valued at $90,000 while B receives stock valued at $79,000, A has suffered a loss of only 10% while B has suffered a loss of 21%. *The difference between their losses of 11% or $11,000 on the same initial investment, could hardly be deemed insubstantial.* Even though we believe the Tax Court did not apply the proper test, we feel that it reached the correct result." (Page 413) (Emphasis supplied.)

As against this reasoning, there are only the "three cogent factors" upon which the Court below relied (R. 33-35). A few words may be permitted to show that none of them justifies the Court's conclusion.

As to the first, the Court said: "(1) The purpose of the statutory provision demonstrably being to *eliminate* the incidence of taxation from transactions contemplating and effectuating only technical gains and losses, we think the facts at bar clearly call for such a result." (Emphasis supplied.) This is certainly an erroneous approach. The statutory provision involved first appeared in 1921. As pointed out in *Halliburton v. Commissioner,* 78 F. 2nd 265, at page 269, and indeed recognized in the opinion of the Court below (R. 32), the report of the Senate Finance Committee declares that the section was intended to provide *new rules* for such exchanges. Unless the exchange conforms to the new rules, the incidence of taxation is not eliminated. Under Section 203 (a) of the Revenue Act of 1926 the entire gain is recognized unless the exception in Section 203 (b) (4) applies. And this exception applies by its terms *only* when the stock received by each transferor is substantially in proportion to his interest in the property prior to the exchange. There is, therefore, no presumption in favor of a tax-free exchange as the Court below seems to hold.

As to the second cogent factor, we think the Court relies on a misstatement of the statute. The Court says

(R. 34): "The statutory provision requires that the interest acquired by each person be in substantial '*proportion* to his interest in the *property* prior to the exchange.'" The Act does not mention "the interest acquired by each person" but on the contrary refers to "the stock and securities received by each." Having based its premise upon a mistake the Court wrongly concludes that the interest acquired by each person means his fractional interest or percentage in the total stock issued. Such a conclusion cannot logically be inferred from the words used in the statute—"stock and securities received by each." These words contemplate the value of the stock received by each transferor as a unit and not as a fractional interest in the stock issued. This conclusion is strengthened by the consideration of the Revenue Act of 1921 discussed below under the third factor.

Nor would the intent of the statute be defeated as the Court suggests, if but a single share or two was given to a person who contributed nothing. The proportionate interest requirement of the statute applies only to the *transferors,* so that a non-contributory stockholder may be disregarded.

The third cogent factor influencing the Court below (Opinion, R. 35) was the somewhat similar but different words used in the Revenue Act of 1921. If, as stated in the opinion of the Court of Appeals, Section 203 (b) (4) of the Revenue Act of 1926 is but a re-wording of Section 202 (c) (3) of the Revenue Act of 1921 which reads "and the amount of stock . . . received by *such persons* are in substantially the same proportion as their interests in the property before such transfer" it logically follows that the relative value test and not the control test applies. Substituting for "such persons" in the instant case "Gilbert and Josephine" we find the test to be that the amount of stock received by Gilbert ($49,500) and the amount of stock received by Josephine ($39,500) shall be in substantially the same proportion as the interest of Gilbert ($45,000) and the interest of Josephine ($45,000) in the property be-

fore the transfer. The section does not contemplate a comparison between the amount of stock received by each transferor with the aggregate stock issued, or the interest of each transferor with the aggregate property transferred, but only the amounts of stock received by *each* and the interests of *each* transferor prior to the transfer. In none of the Revenue Acts is there any reference to the total stock issued or the total property transferred. That at least is certainly the mathematical definition of "proportion" which is defined by Webster's International Dictionary, 2nd Edition: "The equality of the ratios, . . . or a relation among quantities that the quotient of the first divided by the second equals that of the third divided by the fourth."

Which line of reasoning should prevail? The "three cogent factors" of the Third Circuit or the reasoning of the First and Fourth Circuits? We believe that the conflict alone is so serious as to fully justify this Court's granting certiorari without more. So we submit that this Court should take jurisdiction not only because the decision of the Court below for the first time really caused the conflict of Circuits but also because it is on the wrong side of the conflict. We make that statement the more confidently because an impartial commentator in the "Rewrite Bulletin Division" of the 1949 C. C. H. Tax Service, page 11386, has made a careful analysis of the opinion below and has written rather critically of the result reached.

II.

The Court Below Has Misconstrued the Amendment to the Revenue Act of 1926 in Such a Way as to Ignore Its Most Important Provision.

Section 203 (b) (4) of the Revenue Act of 1926 was amended by Section 213 (h) (1) of the Revenue Act of 1939 (53 Stat. 872; 26 U. S. Code Ann. "Internal Revenue Acts, 1924 to date," page 1178). It is printed in full (Appendix 27). So far as relevant to this case, the amend-

ment added the following sentence to Section 203 (b) (4) as originally enacted (supra, page 15):

> "Where the transferee assumes a liability of a transferor, or where the property of a transferor is transferred subject to a liability, then for the purpose only of determining whether the amount of stock or securities received by each of the transferors is in the proportion required by this paragraph, the amount of such liability (if under section 213 of the Revenue Act of 1939 it is not considered as 'other property or money') shall be considered as stock or securities received by such transferor".[2]

The Court below has resorted to the above provision in the second part of its opinion to justify its holding that the stock and securities received are substantially in proportion even though the relative value test is used. It does this by considering some liabilities in the amount of $1,499,978.78 as stock and securities under the above amendment.

But clearly the amendment does not say liabilities assumed shall be stock and securities in all cases. On the contrary it says they shall be stock or securities only if under Section 213 of the Revenue Act of 1939 the amount of liability is not considered as "other property or money." This is the parenthetical clause of the amendment which the Court below ignored completely. It requires a consideration of Section 213 of the Revenue Act of 1939.

Section 213 (f) (1) of the Revenue Act of 1939 (53 Stat. 871; 26 U. S. Code Ann. "Internal Revenue Acts 1924 to date" page 1177) appears in Appendix (29). Here, for clarity, we present it in a condensed form:

> "(f) ASSUMPTION OF LIABILITY NOT RECOGNIZED UNDER PRIOR ACTS. (1) Where upon an exchange . . . the taxpayer received as part of the considera-

2. This is now the second sentence of Section 112 (b) (5) of the Code.

> tion property which would be permitted by subsection . . . [203 (b) (4) of the 1926 Act] to be received without the recognition of gain if it were the sole consideration, and as part of the consideration another party to the exchange assumed a liability of the taxpayer . . . , such assumption . . . shall not be considered as 'other property or money' received by the taxpayer . . . and shall not prevent the exchange from being within the provisions of subsection . . . [203 (b) (4) of 1926 Act]; except that if . . ."[3]

That section says the assumed liabilities shall not be considered other property or money in a case "where upon an exchange . . . the taxpayer [Gilbert Mather] received as part of the consideration property [preferred and common stock] which would be permitted . . . to be received without the recognition of gain if it were the sole consideration." But as we have already shown in the first portion of this brief, if the preferred and common stock were the sole consideration, Gilbert Mather would nevertheless be taxable on his gain. Hence the transaction described in Section 213 (f) (1) of the Revenue Act of 1939 does not meet the condition required by Section 213 (h) (1) and there is left only Section 203 (b) (4) of the Revenue Act of 1926 as originally enacted to govern the facts of this case.

That construction is the only possible construction when the purpose of the amendment is recalled. In *Helvering v. Southwest Corporation*, 315 U. S. 194 (1942) this Court said, p. 199:

> "We search the legislative history of the 1939 amendment in vain for any indication that it was designed to do more than to alter the rule of the *Hendler* case."

In the case of *U. S. v. Hendler*, 303 U. S. 564 (1938), this Court held that under the facts involved in that case

3. This is now Section 112 (k) of the Code.

liabilities assumed were other "property or money," and hence the transfers there made were not made "solely in exchange for stock or securities." The result of the *Hendler* decision was that a transfer otherwise tax-free was made taxable because liabilities had been assumed. The purpose of the amendment was to overcome that result. That statement is beyond question. The Report of the House of Representatives (See Appendix 31) says that the interpretation given *U. S. v. Hendler* "will largely nullify the provisions of existing law which postpone the recognition of gain in such cases," i. e., where liabilities are assumed. In short, the purpose of the amendment was to provide that transfers otherwise tax-free should remain so even though liabilities are assumed. It was never the intention of the Congress to make any change as to transfers which were otherwise taxable.

This conclusion would seem to be beyond question when there is considered not only the Report of the House (Appendix 31) but also T. D. 4939 (Appendix 32) and Section 29.112 (k) Regulations 111 (Appendix 32) where the Rulings and Regulations of the Commissioner adopt a construction which is in complete accord with petitioner's contention.

In summary, it seems to petitioner that the basic error of the respondent's position is his apparent assumption that liabilities assumed must *always* be considered as stock or securities for the purpose of determining the "substantially in proportion," and the Court's decision is to the same effect. But the law does not say so. The law says liabilities assumed shall be considered stock or securities *only* if the liabilities assumed are not other property or money under Section 213. That condition is in effect ignored by the Circuit Court. Petitioner contends it cannot be ignored. By Section 213, Congress tried to make it clear that if a transaction were otherwise tax free, the fact that liabilities were assumed should not make it taxable. Hence the section provided that where the transactions

were otherwise tax free, liabilities assumed should not be considered "other property or money," for if they were considered other property or money there might be taxable gain under the *Hendler* case. Congress was not dealing with a case where a taxpayer was taxable on his gain as in the Mather transaction. If Section 213 is not so limited, why was the condition put in the amendment to Section 203 (b) (4)? And if Section 213 (f) applies both to transactions which were otherwise tax free and those otherwise taxable, it was not necessary to provide for its conditional application as has been done. Unless the condition in the amendment to Section 203 (b) (4) is disregarded respondent cannot prevail. If the amendment and Section 213 are given their natural meaning, the decision of the Circuit Court must be reversed.

Conclusion.

So there are two reasons why this Court should take jurisdiction and reverse the Court below: (1) The decision of the Court below is not only contrary to the decisions in other Circuits but is erroneous; (2) The decision of the Court below has misconstrued a statute and by so doing has decided an important question of Federal law which has not been, but should be, settled by this Court. That is particularly true where the express purpose of the statute, as everyone concedes, was to alter a decision of this Court.

Respectfully submitted,

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Appendix.

STATUTES INVOLVED.

Section 203 (a) Revenue Act of 1926.

(a) Upon the sale or exchange of property the entire amount of the gain or loss, determined under Section 202, shall be recognized, except as hereinafter provided in this section.

Section 203 (b) (4) Revenue Act of 1926 as Originally Enacted.

4. No gain or loss shall be recognized if property is transferred to a corporation by one or more persons solely in exchange for stock or securities in such corporation, and immediately after the exchange such person or persons are in control of the corporation; but in the case of an exchange by two or more persons this paragraph shall apply only if the amount of the stock and securities received by each is substantially in proportion to his interest in the property prior to the exchange.

Section 203 (b) (4) Revenue Act of 1926 as Amended by Section 213 (h) (1) Revenue Act of 1939.

[This is now Section 112 (b) (5) of the Code.]

4. No gain or loss shall be recognized if property is transferred to a corporation by one or more persons solely in exchange for stock or securities in such corporation, and immediately after the exchange such person or persons are in control of the corporation; but in the case of an exchange by two or more persons this paragraph shall apply only if the amount of the stock and securities received by each

is substantially in proportion to his interest in the property prior to the exchange. Where the transferee assumes a liability of a transferor, or where the property of a transferor is transferred subject to a liability, then for the purpose only of determining whether the amount of stock or securities received by each of the transferors is in the proportion required by this paragraph, the amount of such liability (if under Section 213 of the Revenue Act of 1939 it is not considered as "other property or money") shall be considered as stock or securities received by such transferor. If, as the result of a determination of the tax liability of the taxpayer for the taxable year in which the exchange occurred, by a decision of the Board of Tax Appeals or of a court which became final before the ninetieth day after the date of the enactment of the Revenue Act of 1939, or by a closing agreement, the treatment of the amount of such liability was different from the treatment which would result from the application of the preceding sentence, such sentence shall not apply and the result of such determination shall be deemed proper.

Section 204 (a) (8) Revenue Act of 1926.

[This is now Section 113 (a) (8) of the Code.]

8. If the property (other than stock or securities in a corporation a party to a reorganization) was acquired after December 31, 1920, by a corporation by the issuance of its stock or securities in connection with a transaction described in paragraph (4) of subdivision (b) of Section 203 (including, also, cases where part of the consideration for the transfer of such property to the corporation was property or money in addition to such stock or securities), then the basis shall be the same as it would be in the hands of the transferor, increased in the amount of gain or decreased in the amount of loss recognized to the transferor upon such transfer under the law applicable to the year in which the transfer was made.

Section 213 (f) (1) Revenue Act of 1939.

[This is now Section 112 (k) of the Code.]

(f) Assumption of Liability Not Recognized Under Prior Acts.—(1) Where upon an exchange occurring in a taxable year ending after December 31, 1923, and beginning before January 1, 1939, the taxpayer received as part of the consideration property which would be permitted by subsection (b) (4) or (5) of Section 112 of the Revenue Act of 1938, or the corresponding provisions of the Revenue Act of 1924 or subsequent revenue Acts, to be received without the recognition of gain if it were the sole consideration, and as part of the consideration another party to the exchange assumed a liability of the taxpayer or acquired from the taxpayer property subject to a liability, such assumption or acquisition shall not be considered as "other property or money" received by the taxpayer within the meaning of subsection (c), (d), or (e) of Section 112 of the Revenue Act of 1938, or the corresponding provisions of the Revenue Act of 1924 or subsequent revenue Acts, and shall not prevent the exchange from being within the provisions of subsection (b) (4) or (5) of Section 112 of the Revenue Act of 1938, or the corresponding provisions of the Revenue Act of 1924 or subsequent revenue Acts; except that if etc. etc.

* * * * * *

(2) Paragraph (1) shall be effective with respect to the Revenue Act of 1924 and subsequent revenue Acts as of the date of enactment of each such Act.

Section 113 (a) and 113 (a) (8) of the Code.

(a) Basis (Unadjusted) of Property.—The basis of property shall be the cost of such property; except that—

* * * * * *

(8) Property Acquired by Issuance of Stock or as Paid-in Surplus.—If the property was acquired after December 31, 1920, by a corporation—

(A) by the issuance of its stock or securities in connection with a transaction described in Section 112 (b) (5) (including, also, cases where part of the consideration for the transfer of such property to the corporation was property or money, in addition to such stock or securities), or

(B) as paid-in surplus or as a contribution to capital, then the basis shall be the same as it would be in the hands of the transferor, increased in the amount of gain or decreased in the amount of loss recognized to the transferor upon such transfer under the law applicable to the year in which the transfer was made.

Section 112 (b) (5) of the Code.

(5) Transfer to Corporation Controlled by Transferor.—No gain or loss shall be recognized if property is transferred to a corporation by one or more persons solely in exchange for stock or securities in such corporation, and immediately after the exchange such person or persons are in control of the corporation; but in the case of an exchange by two or more persons this paragraph shall apply only if the amount of the stock and securities received by each is substantially in proportion to his interest in the property prior to the exchange. Where the transferee assumes a liability of a transferor, or where the property of a transferor is transferred subject to a liability, then for the purpose only of determining whether the amount of stock or securities received by each of the transferors is in the proportion required by this paragraph, the amount of such liability (if under subsection (k) it is not to be considered as "other property or money") shall be considered as stock or securities received by such transferor.

Section 112 (k) of the Code.

(k) Assumption of Liability Not Recognized.—Where upon an exchange the taxpayer receives as part of the consideration property which would be permitted by subsec-

tion (b) (4), (5), or (10) of this section to be received without the recognition of gain if it were the sole consideration, and as part of the consideration another party to the exchange assumes a liability of the taxpayer or acquires from the taxpayer property subject to a liability, such assumption or acquisition shall not be considered as "other property or money" received by the taxpayer within the meaning of subsection (c), (d), or (e) of this section and shall not prevent the exchange from being within the provisions of subsection (b) (4), (5), or (10); except that if . . .

REPORT NO. 855—HOUSE OF REPRESENTATIVES, 76TH CONGRESS.

In Report No. 855 of the House of Representatives, Seventy-Sixth Congress, First Session (1939-2 Cum. Bull. page 518-9) on the bill which became the 1939 amendment there appears the following:

> "The recent Supreme Court case of *United States v. Hendler* (303 U. S. 564 (1938)) has been broadly interpreted to require that, if a taxpayer's liabilities are assumed by another party *in what is otherwise a tax free* reorganization, gain is recognized to the extent of the assumption. In typical transactions changing the form of entity of a business it is not customary to liquidate the liabilities of the business and such liabilities are almost invariably assumed by the corporation which continues the business. Your committee therefore believes that such a broad interpretation as is indicated above will largely nullify the provisions of existing law which postpone the recognition of gain *in such cases.* To enable bona fide transactions *of this type* to be carried on without the recognition of gain, the committee has recommended Section 213 of the bill.

"Section 213 (a) of the bill amends Section 112 of the Internal Revenue Code by adding a new subsection (k) which provides that *in transactions otherwise within section* 112 (b) (4) or (5), or 112 (c) or (d) (insofar as they relate to exchanges under Section 112 (b) (4) or (5)) gain shall not be recognized to the transferor on account of the assumption of liabilities or the transfer of property subject to liability." (Emphasis supplied.)

T. D. 4939 (1939-2 ANN. BULL. 112) IN PART. QUOTED PORTION—SECTION 20 A. 2, page 116.

"The effect of Section 213 of the Act is to *prevent* certain types of assumptions of liabilities from resulting in a denial of nonrecognition of gain or loss in whole or in part *in cases where, but for such assumption of liabilities, gain or loss would have been unrecognized in whole or in part under the Sections affected.* It does not add to the exceptions now contained in Section 112. It merely implements them." (Emphasis supplied.)

SECTION 29.112 (k) REGULATIONS 111, IN PART.

1. Liabilities assumed are not to be treated as "other property or money" under Section 112 (e) or for the purpose of determining the amount of the realized gain which is to be recognized under Section 112 (c) or (d), *if the transactions would, but for the receipt of "other property or money", have been exchanges of the type described in Section 112 (b) (4)* or (5); and,

2. If the only type of consideration received by the transferor in addition to that permitted to be received by Section 112 (b) (4) or (5) consists of an assumption of liabilities, the transaction, *if otherwise qualified,* shall be deemed to be within the provision of Section 112 (b) (4) or (5). (Emphasis supplied.)

INDEX

CITATIONS

834893—49——1

In the Supreme Court of the United States

October Term, 1948

No. 682

Mather & Co., petitioner

v.

Commissioner of Internal Revenue

ON PETITION FOR A WRIT OF CERTIORARI TO THE UNITED STATES COURT OF APPEALS FOR THE THIRD CIRCUIT

BRIEF FOR THE RESPONDENT IN OPPOSITION

OPINIONS BELOW

The opinion of the Tax Court (R. 17a–25a) is reported at 7 T. C. 1440. The opinion of the Court of Appeals (R. 29–39) is reported at 171 F. 2d 864.

JURISDICTION

The judgment of the Court of Appeals was entered January 3, 1949 (R. 40). The petition for a writ of certiorari was filed March 31, 1949. The jurisdiction of this Court is invoked under 28 U. S. C. 1254.

QUESTIONS PRESENTED

This case presents the question whether under Section 113 (a) (8) of the Internal Revenue Code the cost basis of real property transferred to a corporation by the members of a partnership in exchange for all of the corporate stock and the assumption of the transferors' liabilities, is the same as it was in the hands of the transferors. This directly depends on whether the exchange was tax-free in that it met the requirement of Section 112 (b) (5) that "the amount of the stock and securities received by each * * * [transferor be] substantially in proportion to his interest in the property prior to the exchange". This, in turn, depends on the answer to two independent questions:

(1) Whether the amounts of liabilities assumed by the transferee may, as the Tax Court and the court below held, be considered as "stock and securities received by" the transferors in determining whether the statutory test is met, although, disregarding the assumed liabilities and considering only other assets transferred, that test is not met; and,

(2) Whether the statutory test requires a comparison between the percentage interest held by each transferor in the transferred property before, and his percentage interest in the corporate stock and securities after, the exchange, as the court below held, rather than a comparison between the change in value of each transferor's

interest after the exchange with the change in value of every other transferor's interest.

STATUTES AND REGULATIONS INVOLVED

Internal Revenue Code:

SEC. 112. RECOGNITION OF GAIN OR LOSS.

(a) *General rule.*—Upon the sale or exchange of property the entire amount of the gain or loss, determined under section 111, shall be recognized, except as hereinafter provided in this section.

(b) *Exchanges Solely in Kind.*—

* * * * *

(5) [as amended by Sec. 213, Revenue Act of 1939, c. 247, 53 Stat. 862] *Transfer to Corporation Controlled by Transferor.*—No gain or loss shall be recognized if property is transferred to a corporation by one or more persons solely in exchange for stock or securities in such corporation, and immediately after the exchange such person or persons are in control of the corporation; but in the case of an exchange by two or more persons this paragraph shall apply only if the amount of the stock and securities received by each is substantially in proportion to his interest in the property prior to the exchange. Where the transferee assumes a liability of a transferor, or where the property of a transferor is transferred subject to a liability, then for the purpose only of determining whether the amount of stock or securities received by each of the transferors is in the proportion required by this

> paragraph, the amount of such liability (if under subsection (k) it is not to be considered as "other property or money") shall be considered as stock or securities received by such transferor.
>
> * * * * *

(26 U. S. C. 1946 ed., Sec. 112.)

The other pertinent statutes and regulations appear in the Appendix, *infra,* pp. 20–30.

STATEMENT

The facts as found by the Tax Court (R. 17a–22a) may be summarized as follows:

The taxpayer, a Pennsylvania corporation, was incorporated on December 1, 1926, as the successor to a company founded in 1887 by Charles Mather which went through various partnership phases, the final partnership, preceding the taxpayer's incorporation, having been formed in 1925 (R. 17a, 18a). The partners and their respective interests in the partnership property and earnings were as follows (R. 18a):

Charles Mather	35 percent
Victor Mather	25 percent
Gilbert Mather	20 percent
Josephine Mather	20 percent

On October 29, 1926, the partners entered into a written agreement, whereby they agreed to incorporate the business and form the taxpayer with an authorized capital stock of $510,000, consisting of 5,000 shares of six percent cumulative preferred stock of a par value of $100 per share, and 1,000 shares of common stock of the par value

of $10 per share, and an agreed value at the time of transfer of $50 per share. Only the common stock had voting rights (R. 18a).

Pursuant to the agreement all the assets and good will of the partnership, except those of the New York office, were transferred to the taxpayer. Accounts payable were assumed as a liability. The assets and liabilities were as follows (R. 18a):

Cash	$162, 963. 18
Notes receivable	79, 612. 45
Accounts receivable	1, 054, 403. 15
Bank stock	3, 000. 00
Current assets	1, 299, 978. 78
Real estate	150, 000. 00
Furniture and fixtures	35, 000. 00
Total	1, 484, 978. 78
Partnership indebtedness (accounts payable)	1, 290, 978. 78

The good will of the partnership was $40,000 (R. 19a).

In the exchange the partners received the following number of shares of the taxpayer's preferred and common stock, the common stock being "issued in consideration of the purchase of the good will of the going business" of the partnership (R. 19a):

	Preferred shares	Common
Charles Mather	648	250
Victor Mather	462	250
Gilbert Mather	370	250
Josephine Mather	370	50
Total	1, 850	800

The remaining 200 shares of authorized common stock were unissued (R. 19a).

In addition and also pursuant to the October 1926 agreement, Charles Mather subscribed for the remaining 3,150 shares of preferred stock. These shares were issued to him in exchange for his promissory note in the amount of $50,000 and the conveyance to the corporation of certain parcels of realty in Philadelphia. Both parcels were owned individually by the transferor at the time of the transfer late in December 1926, and the transfer was made effective as of January 1, 1927 (R. 19a). As of December 31, 1926, these parcels of realty had a combined fair market value of $465,000 but were encumbered by mortgages aggregating $200,000. Each parcel was transferred to taxpayer subject to its respective mortgage (R. 20a).

The following tabulation (which we have designated as Table I) shows the values of the properties transferred to the taxpayer, the amount of indebtedness assumed by the taxpayer, the total value of stock and indebtedness received by or attributable to each transferor,[1] and the gain or loss of each; good will is valued at $40,000, common stock at $50 per share, preferred stock at $100 per share (R. 19a):

[1] The partnership indebtedness assumed by the new corporation is distributed according to each partner's percentage interest in the partnership. The indebtedness attributed to Charles Mather as an individual represents the mortgage debt assumed by the taxpayer.

TABLE I

	A	Value received			E	F	G
	Value of properties transferred	B Indebtedness	C Preferred stock	D Common stock	Total indebtedness and stock	Gain (loss)	Percentage of column F to column A
Charles Mather (individual):							
Real estate....$465,000.00							
Note.......... 50,000.00	$515,000.00	$300,000.00	$215,000.00		$515,000.00		
Charles Mather (partnership), 35% interest	533,742.57	454,992.57	64,800.00	$12,500.00	532,292.57	($1,450.00)	−0.2716685%
Victor Mather (partnership), 25% interest	381,244.70	324,994.70	46,200.00	12,500.00	383,694.70	2,450.00	+0.6426316%
Gilbert Mather (partnership), 20% interest	304,995.76	259,995.76	37,000.00	12,500.00	309,495.76	4,500.00	+1.47549%
Josephine Mather (partnership), 20% interest	304,995.75	259,995.75	37,000.00	2,500.00	299,495.75	(5,500.00)	−1.8033081%
Total	2,039,978.78	1,499,978.78	500,000.00	40,000.00	2,039,978.78		

The difference between the greatest gainer and the greatest loser is less than 3.28 percent (R. 20a).

The basis of taxpayer's transferor (Charles Mather) for the real properties in question is as follows (R. 20a, 22a):

	Land	Buildings	Total
1325 Arch Street	$75,250.00	$6,468	$81,718.00
1327 Arch Street	59,579.67	6,468	66,047.67
2039 Chestnut Street	15,000.00	5,000	20,000.00

In his individual income tax return for the calendar year 1926, Charles Mather reported a gain of $124,700 upon the transfer of these properties and an income tax liability of $15,587.50 thereon. Neither Charles Mather nor any of the other partners of Mather & Company reported in their income tax returns any gain or loss on the exchange of partnership assets, under and subject to all partnership liabilities, to the taxpayer for taxpayer's preferred and common stock (R. 20a).

On December 31, 1942, taxpayer sold the Arch Street property for the sum of $20,000 and incurred expenses in connection therewith of $1,025. It claimed a loss as a result of the sale in its 1942 income tax return in the amount of $270,000, computed as follows (R. 21a):

Cost	$350,000
Depreciation, allowed or allowable, being the full value of the improvements (buildings were torn down in 1934)	60,000
	290,000
Gross sales price	20,000
Claimed loss	270,000

The Commissioner disallowed the claimed loss and also disallowed as a deduction the expenses of $1,025 (R. 22a). On December 30, 1943, taxpayer sold the Chestnut Street property for the sum of $2,500 and incurred expenses in connection with the sale of $128.50. It claimed a loss on its 1943 income tax return of $82,500, computed as follows (R. 22a):

Cost	$115,000
Depreciation allowed and allowable, being the full value of the improvements (buildings were torn down in 1936)	30,000
Adjusted basis	85,000
Gross sales price	2,500
Claimed loss	82,500

The Commissioner disallowed the claimed loss and also disallowed as a deduction the expenses of $128.50 (R. 22a).

As noted above, the taxpayer had assumed liability on the mortgages on both pieces of property, (*supra*, p. 6). Shortly prior to the sale of the Arch Street property the taxpayer paid off the balance due on the mortgage in the amount of $79,538.50; shortly prior to the sale of the Chestnut Street property the taxpayer paid off the

balance due on the mortgage in the amount of $30,000 (R. 22a).

Throughout the entire period that the Arch and Chestnut Streets properties were owned by the taxpayer they were rented. Depreciation upon the buildings was claimed and allowed until their demolition. The Arch Street buildings were demolished in 1934, and a deduction of $51,600 was claimed and allowed; the Chestnut Street buildings were demolished in 1936, and a deduction of $26,540.35 was claimed and allowed. These amounts represented the 1926 values of the buildings, less depreciation claimed to year of demolition (R. 22a).

The Tax Court held (R. 25a) that the transfer to the taxpayer fell within the tax-free provisions of Section 112 (b) (5), Internal Revenue Code, as amended, *supra*, pp. 3–4, and that the taxpayer's basis was therefore the same as in the hands of its transferor, Charles Mather. That decision concerned itself solely with the first of the two questions presented, *supra*, pp. 2–3 (R. 22a–25a). The Court of Appeals affirmed (R. 32–39) and considered both the questions now in dispute.

ARGUMENT

Two separate issues are presented by the taxpayer's petition. Both of them were decided in the Commissioner's favor by the court below and either is dispositive of the case. As to issue No. 1, *supra*, p. 2, there is concededly no conflict of

decisions, this being a case of first impression. The decisions of the Tax Court and the Court of Appeals were clearly correct on that issue, and there is no need for further review. And while the second issue (*supra*, pp. 2–3) may present a technical—though not an actual—conflict, this case does not provide a proper occasion for disposition of that question, in view of the independent nonconflict ground which requires a determination in favor of the respondent in any event.

Issue No. 1.—Section 112 (b) (5) *supra*, pp. 3–4, provides one of several exceptions to the general rule that upon an exchange of property the entire amount of the gain or loss which has accrued at the time of the exchange will be recognized. The exception covers those cases in which property is transferred to a corporation by one or more persons solely in exchange for its stock and "if the amount of the stock and securities received by each is substantially in proportion to his interest in the property prior to the exchange."

The taxpayer concedes that all the requisites of a tax-free exchange were met except for the latter requirement.

The first issue involves a construction of the second sentence of Section 112 (b) (5) which permits, solely for determining the proportionate interests under the statute, liabilities of the transferors which are assumed by the transferee to be "considered as stock or securities." This pro-

vision was brought into the Code and given retroactive effect as a result of the decision in *United States* v. *Hendler*, 303 U. S. 564. That case held that liabilities assumed by a transferee must be regarded as "other property," and accordingly made taxable those exchanges or reorganizations which involved an assumption of liabilities, because the property was not transferred *solely* for stock or securities as the statute required in order to confer tax-free status.

To neutralize this effect of the assumption of liabilities, the Congress enacted the so-called "Hendler Amendment" (Section 213, Revenue Act of 1939, c. 247, 53 Stat. 862, Appendix, *infra*, pp. 22–25), which provided that in connection with a reorganization (the kind of transaction involved in the *Hendler* case) the assumption of a liability may be "disregarded" (Section 213 (b)), and also that in determining whether the proportionate interest test of Section 112 (b) (5) is met, in the case of an exchange such as this, the value of assumed liabilities may be regarded as "stock or securities." (Section 213 (c).) When applied to the present case, the amendment makes the changes in the interests of the transferors minute regardless of whether the "relative value" test or the "proportionate interest" test is used. See Table I, *supra*, p. 7; *infra*, pp. 13–16. The taxpayer contends, however (Br. 22–26) that such result does not follow because under Section 112 (k)

Internal Revenue Code, Appendix, *infra,* pp. 20–21,[2] the amounts of stock or securities received must be proportionate prior to the computation *including* the liabilities. The Tax Court (R. 22a–25a) and the court below (R. 35–38) rejected this contention for reasons which, on analysis, are clearly correct. The amounts of assumed liabilities are an obvious factor in the determination of the respective amounts of stock and securities to be received by each of the transferors and to ignore them in an initial test of proportionate interests would mean the adoption of a rule equivalent to that which was discarded by the "Hendler" amendment. The courts below, therefore, rightly concluded that the taxpayer's view would tend greatly to thwart the congressional purpose of extending tax-free treatment to exchanges in which insubstantial variations in the ownership interests of the transferors are made when liabilities are *included* in the reckoning.

This case is the first to present the issue. It is of infrequent occurrence and we are aware of no other case involving the question which has been brought into litigation. The decision is correct and, as stated, there is no conflict. It does not warrant review.

Issue No. 2. This issue raises the proper method of calculating the proportionate interests,

[2] Section 112 (k) of the Internal Revenue Code, *infra*, pp. 20–21, is the equivalent of Section 213 (f) of the Revenue Act of 1939, *infra*, pp. 23–24.

aside from the effect of the "Hendler Amendment." (It would only be necessary to decide this question if the first issue were decided contrary to our views). Under the test adopted by the court below (called the "proportionate interest" or "control" test), if the variance in a transferor's position after the exchange is slight in proportion to the whole, the statute is deemed to be satisfied, no gain or loss is recognized, and the transferor's basis for the property is taken by the transferee. In this view, one of the transferors (Gilbert Mather) contributed 8.33% of the net value of the assets and received 9.17% of the stock, a change of but +0.84%, while another (Josephine Mather) contributed 8.33% and received 7.31%, a change of −1.02%.[24] Neither of these changes, less than 2% of the whole, made the interests substantially disproportionate, and no gain or loss was therefore recognized. This construction appears to have been adopted in numerous other cases. *Diescher v. Commissioner,* 110 F. 2d 90 (C. A. 3); *Budd*

[24]

Transferors	(a) Net value of assets at time of transfer	(b) Percentage of total	(c) Value of stock issued to transferor	(d) Percentage of total	(e) Column (d) minus column (b)
Charles Mather	$393,750	72.92	$392,300	72.65	−0.27
Victor Mather	56,250	10.42	58,700	10.87	+0.45
Gilbert Mather	45,000	8.33	49,500	9.17	+0.84
Josephine Mather	45,000	8.33	39,500	7.31	−1.02
Total	$540,000	100.00	$540,000	100.00	....

International Corp. v. *Commissioner,* 143 F. 2d 784 (C. A. 3), certiorari denied, 323 U. S. 802; *Hartford-Empire Co.* v. *Commissioner,* 137 F. 2d 540 (C. A. 2); *Hillyer, Edwards, Fuller* v. *United States,* 52 F. 2d 742 (E. D. La.); *Record Petroleum Co.* v. *Commissioner,* 32 B. T. A. 1270; *Ared Corp.* v. *Commissioner,* 30 B. T. A. 1080; *Gladstone Corp.* v. *Commissioner,* 37 B. T. A. 174; *Straubel* v. *Commissioner,* 29 B. T. A. 516; *Rissman* v. *Commissioner,* 6 T. C. 1105; *Strouse, Adler Co.* v. *Commissioner,* decided June 19, 1944 (1944 P-H T. C. Memorandum Decisions, par. 44,219); *American Security Co.* v. *Commissioner,* decided June 25, 1943 (1943 P-H T. C. Memorandum Decisions, par. 43,308); *Vickers* v. *Commissioner,* decided June 25, 1942 (1942 P-H B. T. A. Memorandum Decisions, par. 42,379); *Fernhome Co.* v. *Commissioner,* decided November 13, 1934 (1934 P-H B. T. A. Memorandum Decisions, par. 34,503). Cf. *Skouras* v. *Commissioner,* 45 B. T. A. 1024. Although it would have made no difference in each of these cases whether the "proportionate interest" test or the "relative value" test, for which the taxpayer contends here, had been adopted, nonetheless the court's comparison of the percentages in each case accords with the "proportionate interest" test.

The taxpayer's position is that the variance must be considered first from the viewpoint of each individual transferor and that variance then

contrasted with the change in every other transferor's interest. Thus, it would compute the percentage changes in Gilbert Mather's interest to be +10.0% and in Josephine Mather's, −12.2%, and conclude that their interests have changed by 22.2%.[25] This type of comparison has been called the "relative value" test. *Bodell* v. *Commissioner*, 154 F. 2d 407, 410 (C. A. 1). As the court below pointed out (R. 24), such a construction reads into the statute a wholly different test from that called for by its purpose and wording. Since Section 112 (b) (5) results in gain or loss being recognized to all or none of the transferors, it follows that the changes in their interests should be considered in the context of the entire transaction. So considered, a change in an individual transferor's interest, though comparatively large with respect to him alone, loses importance when measured against the entire assets transferred and the entire stock and securities received by all transferors. Sig-

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[25]

	(a) Net value of assets at time of transfer	(b) Value of stock issued to transferor	(c) Gain	(d) Loss	(e) Individual gain or loss percentage
Charles Mather	$393, 750	$392, 300	....	$1, 460	−0. 3
Victor Mather	56, 250	58, 700	$2, 450	....	+4. 4
Gilbert Mather	45, 000	49, 500	4, 500	....	+10. 0
Josephine Mather	45, 000	39, 500	....	5 500	−12. 2
	$540, 000	$540, 000	....	....	....

nificantly, the "relative value" test makes taxable only those exchanges in which the *smaller* transferor has his interest changed proportionately greater than those who transfer the bulk of the assets involved. However, any exchange which is tax-free under the "relative value" test is equally tax-free under the "control" test adopted by the court below.

These considerations, clearly relevant under the "reasonably liberal policy" of the statute,[3] were overlooked or disregarded in both of the cases (*Bodell* v. *Commissioner, supra,* and *United Carbon Co.* v. *Commissioner*, 90 F. 2d 43 (C. A. 4)) cited by the taxpayer as in conflict with the present case.

We believe the conflict, if it exists with either of the cases, to be one in principle merely, and not in result. In the *Bodell* case the court was not called upon by the issues presented to choose between the "relative value" and the "control" tests. The Commissioner had argued that under either test the interests received by the transferors were disproportionate and the exchange not tax-free. The choice made by the court between the two tests was therefore unnecessary to its decision. Under the Commissioner's contentions, the result reached is in accord with that

[3] 3 Mertens, Law of Federal Income Taxation, Sec. 20.41, p. 154. Cf. S. Rep. No. 275, 67th Cong., 1st Sess., p. 11 (1939-1 Cum. Bull. (Part 2) 181, 188-189); *Halliburton* v. *Commissioner*, 78 F. 2d 265 (C. A. 9).

of the present case and the statement of contrary views found in the *Bodell* case gives rise only to a technical conflict.[4]

Similarily, the force of the decision in the *United Carbon* case has been dissipated. The *Bodell* opinion (p. 412) points out that the reasoning of the *United Carbon* opinion is unsound. Moreover, the Court of Appeals for the Fourth Circuit specifically rejected the result of that case when, in a later proceeding (*Britt* v. *Commissioner,* 114 F. 2d 10 (C. A. 4)), it held the identical exchange to be tax-free under Section 203 (b) (3) of the Revenue Act of 1926, c. 27, 44 Stat. 9 (which corresponds with Section 112 (b) (4) of the Internal Revenue Code). This was precisely the contrary of the result in the *United Carbon* case, which held the same exchange taxable under Section 203 (b) (4) of the 1926 Act (which corresponds with Section 112 (b) (5) of the Internal Revenue Code). As to the changed result the court said (p. 13), "Such would have been our decision in the prior case had the Commissioner" cited subsection 203 (b) (3) to support his position. Thus, the conflict alleged does not touch upon the ultimate results in either of the two cases cited.

In the light of the nature of the asserted conflict, and of the existence of a correct and ade-

[4] The *Bodell* case is typical in that it is infrequent for a difference between application of one test or the other to be decisive for a determination of tax-free status.

quate basis for the decision below which does not warrant review, we believe that there is no sufficient reason for this Court to consider the second issue in this case.

CONCLUSION

For the reasons stated, the petition for a writ of certiorari should be denied.

Respectfully submitted.

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MAY 1949.

APPENDIX

Internal Revenue Code:

SEC. 112. RECOGNITION OF GAIN OR LOSS.

* * * * *

(k) [as added by Sec. 213, Revenue Act of 1939, c. 247, 53 Stat. 862, and as amended by Sec. 121, Revenue Act of 1943, c. 63, 58 Stat. 21] *Assumption of Liability not Recognized.*—Where upon an exchange the taxpayer receives as part of the consideration property which would be permitted by subsection (b) (4), (5), or (10) of this section to be received without the recognition of gain if it were the sole consideration, and as part of the consideration another party to the exchange assumes a liability of the taxpayer or acquires from the taxpayer property subject to a liability, such assumption or acquisition shall not be considered as "other property or money" received by the taxpayer within the meaning of subsection (c), (d), or (e) of this section and shall not prevent the exchange from being within the provisions of subsection (b) (4), (5), or (10); except that if, taking into consideration the nature of the liability and the circumstances in the light of which the arrangement for the assumption or acquisition was made, it appears that the principal purpose of the taxpayer with respect to the assumption or acquisition was a purpose to avoid Federal income tax on the exchange, or, if not such purpose, was not a bona fide business purpose, such assumption or acquisition (in

the amount of the liability) shall, for the purposes of this section, be considered as money received by the taxpayer upon the exchange. In any suit or proceeding where the burden is on the taxpayer to prove that such assumption or acquisition is not to be considered as money received by the taxpayer, such burden shall not be considered as sustained unless the taxpayer sustains such burden by the clear preponderance of the evidence.

* * * * *

(26 U. S. C. 1946 ed., Sec. 112.)

SEC. 113. ADJUSTED BASIS FOR DETERMINING GAIN OR LOSS.

(a) *Basis (Unadjusted) of Property.*—The basis of property shall be the cost of such property; except that—

* * * * *

(8) *Property Acquired by Issuance of Stock or as Paid-In Surplus.*—If the property was acquired after December 31, 1920, by a corporation—

(A) by the issuance of its stock or securities in connection with a transaction described in section 112 (b) (5) (including, also, cases where part of the consideration for the transfer of such property to the corporation was property or money, in addition to such stock or securities), or

(B) as paid-in surplus or as a contribution to capital,

then the basis shall be the same as it would be in the hands of the transferor, increased in the amount of gain or decreased in the amount of loss recognized to the transferor upon such transfer under the law applicable to the year in which the transfer was made.

* * * * *

(26 U. S. C. 1940 ed., Sec. 113.)

Revenue Act of 1926, c. 27, 44 Stat. 9:

SEC. 203. * * *

(b) * * *

* * * * *

(4) No gain or loss shall be recognized if property is transferred to a corporation by one or more persons solely in exchange for stock or securities in such corporation, and immediately after the exchange such person or persons are in control of the corporation; but in the case of an exchange by two or more persons this paragraph shall apply only if the amount of the stock and securities received by each is substantially in proportion to his interest in the property prior to the exchange.

* * * * *

Revenue Act of 1939, c. 247, 53 Stat. 862:

SEC. 213. ASSUMPTION OF INDEBTEDNESS.

* * * * *

(b) *Amendment to Definition of Reorganization.*—Section 112 (g) (1) of the Internal Revenue Code (relating to definition of reorganization) is amended to read as follows:

"(1) The term 'reorganization' means * * * (C) the acquisition by one corporation, in exchange solely for all or a part of its voting stock, of substantially all the properties of another corporation, but in determining whether the exchange is solely for voting stock the assumption by the acquiring corporation of a liability of the other, or the fact that property acquired is subject to a liability, shall be disregarded, * * *."

(c) *Requirement of Substantially Proportionate Interests.*—Section 112 (b) (5) of the Internal Revenue Code (relating

to requirement of substantially proportionate interests) is amended by adding at the end thereof the following new sentence: "Where the transferee assumes a liability of a transferor, or where the property of a transferor is transferred subject to a liability, then for the purpose only of determining whether the amount of stock or securities received by each of the transferors is in the proportion required by this paragraph, the amount of such liability (if under subsection (k) it is not to be considered as 'other property or money') shall be considered as stock or securities received by such transferor."

* * * * *

(f) *Assumption of Liability not Recognized under Prior Acts.*—

(1) Where upon an exchange occurring in a taxable year ending after December 31, 1923, and beginning before January 1, 1939, the taxpayer received as part of the consideration property which would be permitted by subsection (b) (4) or (5) of section 112 of the Revenue Act of 1938, or the corresponding provisions of the Revenue Act of 1924 or subsequent revenue Acts, to be received without the recognition of gain if it were the sole consideration, and as part of the consideration another party to the exchange assumed a liability of the taxpayer or acquired from the taxpayer property subject to a liability, such assumption or acquisition shall not be considered as "other property or money" received by the taxpayer within the meaning of subsection (c), (d), or (e) of section 112 of the Revenue Act of 1938, or the corresponding provisions of the Revenue Act of 1924 or subsequent revenue Acts,

and shall not prevent the exchange from being within the provisions of subsection (b) (4) or (5) of section 112 of the Revenue Act of 1938, or the corresponding provisions of the Revenue Act of 1924 or subsequent revenue Acts; except that if, in the determination of the tax liability of such taxpayer for the taxable year in which the exchange occurred, by a decision of the Board of Tax Appeals or of a court which became final before the ninetieth day after the date of enactment of the Revenue Act of 1939, or by a closing agreement, gain was recognized to such taxpayer by reason of such assumption or acquisition of property, then for the purposes of section 112 of the Revenue Act of 1938, and corresponding provisions of the Revenue Act of 1924 or subsequent revenue Acts, such assumption or acquisition (in the amount of the liability considered in computing the gain) shall be considered as money received by the taxpayer upon the exchange.

(2) Paragraph (1) shall be effective with respect to the Revenue Act of 1924 and subsequent revenue Acts as of the date of enactment of each such Act.

* * * * *

(26 U. S. C. 1946 ed., Sec. 112.)

(h) *Substantially Proportionate Interests Under Prior Acts.*—

(1) Section 112 (b) (5) of the Revenue Acts of 1938, 1936, 1934, 1932, and 1928, and section 203 (b) (4) of the Revenue Acts of 1926 and 1924 are amended by inserting at the end thereof the following: "Where the transferee assumes a liability of a transferor, or where the property of a transferor is transferred subject to a liability, then for the purpose only of de-

termining whether the amount of stock or securities received by each of the transferors is in the proportion required by this paragraph, the amount of such liability (if under section 213 of the Revenue Act of 1939 it is not considered as 'other property or money') shall be considered as stock or securities received by such transferor. If, as the result of a determination of the tax liability of the taxpayer for the taxable year in which the exchange occurred, by a decision of the Board of Tax Appeals or of a court which became final before the ninetieth day after the date of the enactment of the Revenue Act of 1939, or by a closing agreement, the treatment of the amount of such liability was different from the treatment which would result from the application of the preceding sentence, such sentence shall not apply and the result of such determination shall be deemed proper."

(2) The amendments made by paragraph (1) to the respective Acts amended shall be effective as to each of such Acts as of the date of enactment of such Act.

* * * * *

Treasury Regulations 111, promulgated under the Internal Revenue Code:

SEC. 29.112 (b) (5)-2. TREATMENT OF ASSUMPTIONS OF LIABILITIES.—(a) *Recognition of gain.*—For the effect upon the recognition of gain of an assumption of liabilities in a transfer described in section 112 (b) (5), see section 112 (k) and the regulations prescribed thereunder.

(b) *Computation of proportionate interests required by section 112 (b) (5).*—In any case where an assumption of liabilities is not to be treated as "other property

or money" under section 112 (k), the liabilities so assumed are, for the purpose of determining whether the stock or securities received by the transferors are substantially proportionate to their interests in the property transferred as required by section 112 (b) (5), to be treated as stock or securities received by the transferor whose indebtedness is assumed. * * *

* * * * *

SEC. 29.112 (k)-1 [as amended by T. D. 5402, 1944 Cum. Bull. 229]. ASSUMPTION OF LIABILITIES NOT TO BE TAKEN INTO ACCOUNT FOR PURPOSE OF RECOGNIZING GAIN OR LOSS.—(a) *General rule.*—Section 112 (k) does not affect the rule that liabilities assumed are to be taken into account for the purpose of computing the amount of gain or loss realized under section 111 upon an exchange. Subject to the exceptions and limitations specified in paragraph (b) of this section, section 112 (k) provides, however, that—

(1) Liabilities assumed are not to be treated as "other property or money" under section 112 (e) or for the purpose of determining the amount of the realized gain which is to be recognized under section 112 (c) or (d), if the transactions would, but for the receipt of "other property or money," have been exchanges of the type described in section 112 (b) (4), (5), or (10); and

(2) If the only type of consideration received by the transferor in addition to that permitted to be received by section 112 (b) (4), (5), or (10) consists of an assumption of liabilities, the transaction, if otherwise qualified, shall be deemed to be within the provisions of section 112 (b) (4), (5), or (10.)

With respect to an exchange described in section 112 (b) (10) or so much of section 112 (b) or (e) as refers to section 112 (b) (10), the provisions of section 112 (k) shall not affect the tax liability for any taxable year beginning before January 1, 1943.

The application of this paragraph may be illustrated by the following example:

Example.—A, an individual, transfers to a controlled corporation property with an adjusted basis of $10,000 in exchange for stock of the corporation with a fair market value of $8,000, cash in the amount of $3,000, and the assumption by the corporation of indebtedness of A amounting to $4,000. A's gain is $5,000, computed as follows:

Stock received	$8,000
Cash received	3,000
Liabilities assumed by transferee	4,000
Total consideration received	15,000
Less: Adjusted basis of property transferred	10,000
Gain realized	5,000

Assuming that the transaction falls within section 112 (c) as a transaction which would have been within section 112 (b) (5) but for the receipt of "other property or money", only so much of such $5,000 gain will be recognized as does not exceed the "other property or money" received. Since section 112 (k) provides that an assumption of liabilities shall not constitute "other property or money" for this purpose, the only "other property or money" received is the $3,000 cash, and the $5,000 realized gain will be recognized only to that extent.

(b) *Exceptions and limitations.*—The benefits of section 112 (k) do not extend to any exchange involving an assumption of

liabilities where it appears that the principal purpose of the taxpayer with respect to such assumption was a purpose to avoid Federal income tax on the exchange, or, if not such purpose, was not a bona fide business purpose. In such cases, the amount of the liabilities assumed shall, for the purpose of determining the amount of gain to be recognized upon the exchange in which the liabilities are assumed, be treated as money received by the taxpayer upon the exchange. In any suit or proceeding where the burden is on the taxpayer to prove that an assumption of liabilities is not to be treated as "other property or money" under section 112 (k), which is the case if the Commissioner determines that the taxpayer's purpose with respect thereto was a purpose to avoid Federal income tax on the exchange or was not a bona fide business purpose and the taxpayer contests such determination by litigation, the taxpayer must sustain such burden by the clear preponderance of the evidence. Thus, the taxpayer must prove his case by such a clear preponderance of all the evidence that the absence of a purpose to avoid Federal income tax on the exchange, or the presence of a bona fide business purpose, is unmistakable.

T. D. 4939, 1939-2 Cum. Bull. 112, 116, 118:

*   *   *   *   *

Pursuant to section 213 of the Revenue Act of 1939 and other provisions of the internal revenue laws, the following regulations are hereby prescribed:

*   *   *   *   *

SEC. 20A.3. *Assumption of liability not to be taken into account for purpose of recognizing gain or loss*—(a) *General*

rule.—Section 213 of the Act does not affect the rule that liabilities assumed are to be taken into account for the purpose of computing the amount of gain or loss realized upon an exchange. Such section provides, however, that liabilities assumed are not to be treated as "other property or money" under section 112 (e) or for the purpose of determining the amount of the realized gain which is to be recognized under section 112 (c) or (d), if the transactions involved would, but for the receipt of "other property or money," have been exchanges of the type described in section 112 (b) (4) or (5). The section also provides that if the only type of consideration received by the transferor in addition to that permitted to be received by section 112 (b) (4) or (5) consists of an assumption of liabilities, the transaction, if otherwise qualified, shall be deemed to be within the provisions of section 112 (b) (4) or (5). The above rules are applicable to all transactions of the character described occurring at any time in the past or the future in a taxable year ending after December 31, 1923, of the transferor whose liabilities are assumed, with the exceptions and limitations specified in paragraphs (b) and (c) of this section of the regulations.

* * * * *

SEC. 20A.5 *Effect of assumption of liabilities on computation of proportionate interests required by section 112 (b) (5).*—(*a*) *General rule.*—Subject to the limitations and exceptions specified in paragraph (b) of this section of the regulations, in any case where an assumption of liabilities is not to be treated as "other property or money" under section 213 (f) of the Act

or section 112 (k), added to the Internal Revenue Code by section 213 (a) of the Act, the amount of the liabilities so assumed is to be treated as stock or securities received by the transferor whose indebtedness is assumed, for the purpose of determining whether the stock or securities received by the transferors are substantially in proportion to their interests in the properties transferred, as required by section 112 (b) (5). The application of this paragraph may be illustrated by the following example:

Example: A and B, individuals, each own property with a fair market value of $100,000 on July 1, 1939. There is a purchase money mortgage on A's property of $50,000. On July 1, 1939, A and B organize the X Corporation, to which they transfer the property above described for the entire capital stock of the X Corporation and the assumption by the X Corporation of A's purchase money mortgage. The X Corporation's capital stock is divided as follows: $50,000 to A and $100,000 to B. Nevertheless, for the purposes of determining whether the transferors received stock or securities substantially in proportion to their interests in the properties transferred, as required by section 112 (b) (5), A is deemed to have received stock or securities to the extent of $100,000, since his $50,000 purchase money mortgage, assumed by the X Corporation, is also to be treated as stock or securities received by him. Accordingly, under the facts as stated, the proportions required by section 112 (b) (5) exist.

* * * * *

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